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IMPLICATIONS AND EFFECTS OF THE STOCK DIVIDEND DECISION

The Sixteenth Amendment was passed to make possible the adoption of a form of taxation indispensable to the modern industrial state. To use the succinct language of Justice Holmes, "The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes."¹ In *Eisner v. Macomber* the Supreme Court has given a construction to this Amendment imposing serious restrictions upon the power of the Federal government to tax incomes, and opening the door to the raising of a myriad of nice questions as to what is income. It is the purpose of this article to make clear the far-reaching nature of these restrictions and to urge their undesirability and the need of their abolition.

I

The decision of the Supreme Court is based upon three distinct propositions. The first is that to constitute income there must be realization by separation of income from principal. The second is that separation must be narrowly defined and exists only if certain tests are satisfied. The third is that the corporate entity cannot be ignored in considering whether separation is present.

A

The most fundamental of these propositions is that realization by means of separation is an essential characteristic of income. This assumption is necessary to support the result of the stock dividend decision, for otherwise stock dividends could be treated as income at least to the extent of the difference between the total value of the old and new stock and its cost. To avoid this the principle was enunciated that increase in value is not income until it is realized by separation. This doctrine is expressed as follows:

Income is "not . . . a growth . . . of value in the investment; but a gain . . . severed from the capital". "A stock dividend . . . while indicating that the shareholder is the richer because

¹*Eisner v. Macomber* (1920) 252 U. S. 189, 220, 40 Sup. Ct. 189. For discussions of this decision see, E. R. A. Seligman, *Are Stock Dividends Income*, 9 American Economic Rev. 517; Edward H. Warren, *Taxability of Stock Dividends as Income* (1920) 33 Harvard Law Rev. 885; Thomas R. Powell, *Stock Dividends, Direct Taxes, and the Sixteenth Amendment* (1920) 20 COLUMBIA LAW REV. 536; Charles E. Clark, *Eisner v. Macomber and Some Income Tax Problems* (1920) 29 Yale Law Jour. 735; Montgomery, *Income Tax Procedure* (1921) c. XXI. Certain of the questions dealt with in this article are discussed by these writers but no specific reference thereto will be made.

of an increase of his capital, at the same time shows he has not realized or received any income in the transaction."²

Numerous important results follow from this principle. The first question that arises is whether realization can exist before cash is received. As to this the opinion states:

"Without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax."³

This reasoning would require holding, that when property is exchanged for property of a value greater than the original cost, instead of being sold for cash, there is no income. If this were the law, barter and exchange would soon reappear on the markets and income realized in cash would dwindle to small proportions.

Even if we assume that realization is not limited to the receipt of cash, but may exist when property, which is the equivalent of cash, is received either in exchange for other property or in payment of services, further questions arise. When is property the equivalent of cash? Is property which can be valued in cash the equivalent of cash or is that term limited to property in the nature of liquid assets for which there is an actual existing market? The present position of the Treasury Department is far from clear, but while wavering between the two views, inclines to the first.^{3a} Under the realization test of income this question would seem to be a constitutional one.

Another aspect of this same question is, at what precise moment does realization occur? For example, a farmer cuts his hay and stores it in his barn. Later he uses some for fodder for his cattle and some as payment of wages to his hired man. Thereafter he sells some to a neighbor in exchange for the neighbor's giving him some oats; another portion of the crop he sells to another neighbor, upon the neighbor's agreement to pay a year later; still another portion is sold for a promissory note and finally, the remainder is sold for cash. At just

² *Eisner v. Macomber* (1920) 252 U. S. 189, 207, 212.

³ *Ibid.* 213. This language would seem equally applicable to a dividend paid in stock of another corporation. Such a dividend, however, has already been held to be income. *Peabody v. Eisner* (1918) 247 U. S. 347, 38 Sup. Ct. 546.

^{3a} The clearest expression of the Treasury Department's views are to be found in (1919) Treasury Bulletin No. 19, 494 (Bureau of Internal Revenue) from which the following is an extract: "A case in which property has no 'fair market value' should be regarded as unusual, and a determination that property has no 'fair market value' should not be made lightly. Property is not without 'fair market value' merely because there is a considerable divergence of opinion as to its value. 'Fair market value' is to a large extent a matter of opinion and men of equally wise judgment will differ widely in their opinions. Frequently excellent evidence as to the 'fair market value' of property, especially that which, though not ordinarily traded in, has a value in use, is found in its cost, or in the cost of reproducing it, with adjustments for depreciation and the like."

what time has the farmer received his income? Certainly if the legislature saw fit in all cases to wait until cash was received, such a tax should not be held to be one imposed on capital, on the ground that the farmer had in fact received his income at a prior date than the actual payment of the cash. On the other hand, it would be not unreasonable to go to the other extreme and to say that the farmer had received the equivalent of cash as soon as the hay was cut, and that he then had income to the extent of its value. However, with realization adopted as the test of income, it follows that numerous Treasury Department regulations dealing with cases similar to the illustrations suggested each involve separate constitutional questions, and that it will be urged in each case either that the tax is imposed on increase in capital which has not yet ripened into income, or that it is imposed too late on that which once was income but now is capital.⁴

Again, assuming that property is received which is the equivalent of cash, when is there a sufficient separation to constitute income? The new property, though new in form, in substance may be the old property, as in the incorporation of a partnership or a corporate reorganization, and in such a case there is no true separation from the old property. The line of demarcation is difficult to draw and each different set of facts will present a new constitutional question.

More serious, however, are the immediate effects of the basic assumption that increase in value of capital before realization and separation is not income. One result will be in connection with the procedure under the present Act whereby the value of inventories is included in computing business profits.⁵ Prior to sale the inventory merely represents unrealized income and constitutes an increase in the value of the capital not yet separated from the capital. To include it in ascertaining income is to treat the merchandise as though it had been sold at the inventory value, which is equivalent to treating accretion to capital as income even though there has been no realization by separation. The principle upon which the stock dividend decision is based seems necessarily to lead to the conclusion that such procedure is unconstitutional.

Inventories, however, do not present the only case in which accretion to capital should be recognized as income within the Constitution. It is true that as a matter of legislative policy it is probably desirable to tax accretions to capital only in exceptional cases; since taxes must be paid in money it is but fair that income should be considered as income for the purpose of taxation only when it has been realized in cash or in its equivalent, separated from the original capital. This, however, is a

⁴The most important question of this nature is the validity of the accrual basis of computing business income. For a discussion of this and other analogous cases see Prof. T. S. Adams, *When is Income Realized in The Federal Income Tax*, Columbia University Press 1921.

⁵Revenue Act of 1918, Sec. 203, U. S. Comp. Stat. (Supp. 1919) § 6336½ c.

question of policy, and this particular view of policy may not be followed by future legislatures.^{5a} It may well be that within a decade it will seem desirable to Congress in certain cases to tax as income accretion to capital before it is realized by separation and to compel the owner of property readily marketable, such as securities, which increases in value, to sell a part of his property if necessary in order to pay his taxes. This certainly is a conceivable position for a legislature to take, and if carefully limited would work no greater hardship than the present law which treats as income gain resulting from the exchange of property for property.⁶ Under the realization by separation test, however, such legislation would be unconstitutional.

So far we have been pointing out that realization as a requirement of income will unduly curtail the power of Congress to tax. It should be noted, however, that from another aspect this doctrine will unduly increase the power of Congress to tax. Consider a piece of real estate which was bought in 1910 for \$100,000, which was worth \$150,000 on March 1, 1913, and which is sold today for \$150,000. Since accretion to capital is not income, if an income tax law had been in effect throughout the period from 1910 to the present time, the owner of the property could not have been taxed during prior years on the appreciation in its value as part of his income; but he would have been taxed on a \$50,000 gain in 1921. Since this is the case, what should the situation be if the income tax amendment and the income tax legislation first became effective on March 1, 1913? When the property is sold in 1921 the taxable income would still necessarily be \$50,000. Yet in *Lynch v. Turrish* the Supreme Court stated that

"if increase in value of the lands was income, it had its particular time and such time must have been within the time of the law to be subject to the law, that is, it must have been after March 1, 1913"

and held that where such increase in value was prior to 1913, though the realization was after 1913, there was no taxable gain.⁷ If increase in value is income at the time of the increase then income exists before realization. Such a holding is wholly inconsistent with the realization test of income, and if that test is to be consistently followed, the earlier decision must be considered to be reversed.^{7a}

^{5a}It is interesting to note in this connection that since 1917 Germany has had a tax upon unrealized accretion in value to capital. See 37 *Finanz-Archiv* p. 306.

⁶These two cases emphasize the importance of separation as an element in realization; as far as increase in wealth, in form equivalent to cash, is concerned, they are alike, but they differ in that in the one the taxpayer has voluntarily parted with his appreciated property and taken in its place in separated form new property, while in the other there has been no separation and the increase in value is still bound up with the old property.

⁷(1918) 247 U. S. 221, 229, 38 Sup. Ct. 537.

^{7a}Another form of this question appears where property was bought in 1910 for \$150,000, was worth \$100,000 on March 1, 1913, and is sold today for \$125,000. The War Revenue Act of 1918 in Section 202-a declares that in such a case there is taxable income to the extent of \$25,000. Yet if realization is the test of income

Equally important is the effect of the realization test upon any possible legislative attempt to close the chief loophole for tax-evasion existing under the present Income Tax Act. Reference is had to the provision whereby A, who has property worth more than its cost to him, can transfer it to his relative B by *inter vivos* gift or testamentary disposition, and B will thereupon sell it and will be subject to no tax upon the sale. In this manner A will avoid realizing any profit, while at the same time he takes care to sell that property which has depreciated in value since its purchase and thus realize his losses and decrease his taxable income. Two methods of stopping the loophole have been suggested. In a Bill which passed the House of Representatives in May, 1920, and is now pending, it is proposed to tax gain upon the sale by the donee of gifts upon the same basis as if the sale were being made by the donor.⁸ On the other hand, under the New York Income Tax Act, a gift is treated as a realization and consequently taxed to the donor at the time of disposition.⁹ Under the principles of *Eisner v. Macomber* both of these methods would seem to have been rendered unconstitutional. The donee cannot be taxed upon subsequent sale by him because none of the elements of income as defined by the Court are present; he is merely selling his capital and realizing no gain upon the sale. No more can the donor be taxed; income requires realization in cash or its equivalent—mere increase in wealth even though in a disposable form is not such.

A third method of meeting the difficulty which has not as yet been advocated would be to tax gifts as income to the donee at the time of receipt by him, to the extent of the difference between their then value and their cost to the donor. This would perhaps be considered as an opening wedge in an attempt to tax all gifts and inheritances as income, and probably would be similarly forbidden under the realization by separation test of income.

Finally, realization as a test of income will bar another desirable change in our Income Tax Law. A type of income which is frequently overlooked is the income derived from the enjoyment of property owned

and a transaction is not considered closed until income is realized, the intermediate value on March 1, 1913, whether more or less than cost, must be ignored, and the difference between the cost and selling price should alone be considered. On this basis there would be no realized gain in the illustration suggested. Whether there would be a deductible loss of \$25,000 and whether the statute in so far as it refuses to recognize such a loss is also unconstitutional depends upon an entirely different question, namely whether income in the constitution means gross income or net income. While there is no square decision of the Supreme Court upon this point, an arbitrary limitation upon the amount of interest deductible by a corporation was supported in *Brushaber v. Union Pac. R. R.* (1916) 240 U. S. 1, 36 Sup. Ct. 236. It would seem to follow from this decision that Congress has power to tax gross income and therefore may allow such deductions only in computing net income as it sees fit.

⁸ 66th Congress, 2nd Session, H. R. 14198. This does not apply to inheritances.

⁹ Comptroller's Regulations, New York State Personal Income Tax, Cons. Laws (1909) c. 60, § 91. The validity of this regulation has been attacked in a case now pending in the Third Department of the New York Appellate Division, *People ex rel Wilson v. Wendell*.

by the taxpayer. Such income is not income in the sense of money income but is income in the broad sense. A is a taxpayer with an income of \$10,000 a year and pays \$2,000 a year as rental. B is another taxpayer with an income of \$8,000 a year and owns a home of just the same kind as that for which his neighbor A pays \$2,000 a year rent. In a very real sense, are not the incomes of these two neighbors just the same and does not the rental value of the house owned by B in which he lives represent an addition to his income of \$2,000 a year? That this is income was recognized under the Income Tax Act of 1862.¹⁰ Under the realization by separation test, however, such a provision would seem unconstitutional.¹¹

B

The second fundamental proposition declared in *Eisner v. Macomber* is that the separation necessary to constitute realization must be narrowly defined and exists only if certain tests are satisfied. This is necessary in order to avoid the recognition of stock dividends as income; for, as we shall point out hereafter, if a broader definition of separation were adopted, stock dividends would be income under such a definition.

Two chief requirements of separation are laid down in the decision. The most important of these is that there is no separation unless there is a payment of assets out of the corporate treasury to the stockholder.¹²

From this proposition various conclusions follow. To begin with, a dividend payable in bonds of the corporation declaring the dividend is not income. That this is a necessary logical consequence is admitted by one who approves of the decision:

"So far as the economic principle in question is concerned, all such cases resolve themselves into the simple question: Has something been taken from the corporation's assets and given to the stockholders? If so, the stockholder has received income; if not, he has not received income. The extreme case where a corporation pays a dividend in its own bonds, issued for the purpose, presents a real difficulty. In strict economic theory I should say that this is purely a capital transaction and that, while changing in part the relation between the stockholders and the corporation (making them now also bondholders), it does not involve any income to the stockholders."¹³

From a practical standpoint this result is most unsatisfactory.

¹⁰See Prof. E. R. A. Seligman, *The Federal Income Tax* (1914) 511.

¹¹For an effective criticism of realization as a requirement of income, see Prof. R. M. Haig, *The Concept of Income—Economic and Legal Aspects*, in *The Federal Income Tax*, Columbia University Press 1921.

¹²"The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit." *Eisner v. Macomber*, *supra*, 211.

¹³Prof. F. R. Fairchild, *The Stock Dividend Decision*, 5 Bulletin National Tax Association No. 7, p. 210.

Dividends payable in bonds are just as much income from the stockholder's point of view as dividends in Liberty Bonds, even though there is no payment from the treasury. A *dictum* in the decision, however, makes it doubtful if the Supreme Court intends to follow out its own logic to the bitter end.¹⁴

Another application of this test of separation is that stock dividends payable to preferred stockholders are not income. While dividends of this type are unusual, they are not unknown; the preferred stock provisions may permit the payment of the 7% annual dividend in cash or in stock, either preferred or common, taken at its market value.¹⁵ When such stock dividends are declared the preferred stockholders are enriched to just the same extent as if they had received cash; they have received valuable new rights. Yet on the payment-from-treasury test of income we are forced to the conclusion that they have received no income.

Another similar application of this principle is where a dividend to common stockholders is paid in preferred stock, when there has already been a pre-existing preferred stock outstanding owned by others.¹⁶ As a result of such a dividend the common stockholder's interest which was previously wholly deferred, now in part at least is an interest equal in rank with the preferred. If the earnings in any year do not exceed the preferred dividend requirements, he now shares in them, whereas before he would have been given nothing. His position is thus substantially improved. Yet upon the Court's test of separation there is no income because nothing has been taken from the corporate treasury.¹⁷

The separation-of-assets test leads to another consequence. Under this test it makes no difference if the stock dividend is paid in stock newly issued for the purpose or already issued and at the time owned by the corporation. In neither case are the assets of the corporation diminished by the dividend nor is anything paid out. Logically

"Why should the case where the stock dividend is made with stock which has previously been issued and which the company has bought in be different from a case where the stock which is used for the stock dividend is then issued for the first time?"¹⁸

¹⁴The opinion notes that a stock dividend does not create "a claim against the going concern for any particular sum of money." p. 209.

¹⁵For a recent decision involving a dividend paid in part in cash, in part in preferred and in part in common stock, to preferred stockholders, see *Wilder v. Tax Commission* (1920) 234 Mass. 470, 125 N. E. 689.

¹⁶Of course a dividend paid in preferred stock where there is no preëxisting preferred stock *a fortiori* is not income. This is assumed by the Treasury Department. (1920) Treasury Bulletin No. 47, 1308 (Bureau of Internal Revenue).

¹⁷Both of the two preceding applications of the decision have been apparently recognized by the Treasury Department in its ruling that all stock dividends of every nature are exempt from taxation. (1920) Treasury Bulletin No. 33, 1141. They have also been recognized in the Bill passed by the House of Representatives in May, 1920, which purports to amend the Revenue Act of 1918 so as to declare that no stock dividend shall be subject to tax. 66th Congress, 2nd Session, H. R. 14197.

¹⁸Machen, *Modern Law of Corporations* (1908) § 1385. This language is used

This conclusion, however, lends itself so readily to tax evasion by making possible the substitution of stock dividends for cash dividends through the purchase of stock for the purpose, that the Attorney General of New York has refused to recognize it as a necessary result of the decision, and he has advised that such dividends are not "true" stock dividends.¹⁹

Not only does the decision in *Eisner v. Macomber* make payment out of the corporate treasury a test of separation, but it requires in the second place that the stockholder be enriched. A stock dividend is not income because it

"really takes nothing from the property of the corporation, and adds nothing to the interests of the stockholders. Its property is not diminished, and their interests are not increased. . . . In short, the corporation is no poorer and the stockholder is no richer than they were before. . . . If the plaintiff gained any small advantage by the change, it certainly was not an advantage of \$417,450, the sum upon which he was taxed."²⁰

If gain to the stockholder resulting from the act of separation is essential to income, it follows necessarily that no dividends of any nature can be taxed as income, whether paid in cash or property. For in the case of a cash dividend, prior to the dividend the cash constituted part of the corporate surplus, and its distribution depleted the corporate surplus to the amount of the dividend. Instead of the stockholder being enriched by such a dividend, he is merely taking it out of one pocket and putting it into another; he is not a penny richer by the process and has "gained no advantage by the change" for the value of his stock has decreased by the amount of the dividend.²¹ On this test of separation the conclusion is inescapable that no corporate dividends are taxable. Undoubtedly however the Supreme Court will refuse to be bound by logic and will never reach this result.

The doctrine that gain must result from the act of separation or else there is no income, leads to further revolutionary results. If there is no income unless there is an act of separation which creates an addition to the wealth of the owner, then a sale of assets cannot give rise to income, for it is merely turning into another form the value of the assets which existed before the sale.

with reference to the question of apportionment between life-tenant and remainderman.

¹⁹ (New York) Attorney-General's Income Tax Letter No. 26, March 21, 1920.

²⁰ 252 U. S. at p. 202. This idea is expressed in various parts of the opinion: "Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government contends *etc.*" p. 214; "The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional 1,100 shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values—a thing they do not always do." p. 215.

²¹ "Every dividend distribution diminishes by just so much the assets of the

This necessary consequence of the Supreme Court's premise has been recognized in *Brewster v. Walsh*,²² recently decided, which held, following the principles of *Eisner v. Macomber*, that gain from sale of capital assets cannot be taxed as income. That this decision logically applies the propositions enunciated by the Supreme Court must be admitted. As stated by Judge Thomas:

"The sale of capital results only in changing its form and like the mere issue of a stock dividend, makes the recipient no richer than before."

It may be doubted whether the Supreme Court will itself be so consistent; certain *dicta* in the stock dividend decision suggest that a contrary result will be reached, logic notwithstanding.²³

C

The preceding are the results which follow from the definition of separation adopted by the Supreme Court. Even upon this test of separation, however, stock dividends could be recognized as income if the corporate entity were ignored and a stockholder were treated as a part

corporation, and in a theoretical sense reduces the intrinsic value of the stock". *Lynch v. Hornby* (1918) 247 U. S. 339, 346, 38 Sup. Ct. 543.

²² (D. C., Conn. 1920) 268 Fed. 207. See discussion of this case by Professor Thomas Reed Powell in (1921) 21 COLUMBIA LAW REV. 163.

²³ "It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the 16th Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit." 252 U. S. 212; "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case (pp. 183, 185)." 252 U. S. 207.

A result contrary to that of *Brewster v. Walsh*, *supra*, has been reached in *Merchants' Loan and Trust Company, Trustee v. Smietanka and Eldorado Coal and Mining Co. v. Mager* (U. S. Dist. Court, N. Dist. Ill., Oct. 22, 1920) which have recently been argued on appeal before the Supreme Court, and in *Goodrich v. Edwards* (U. S. Dist. Court, S. Dist. N. Y., Dec. 17, 1920.)

To construe income so as to exclude profit on sale is narrowing the definition unduly. Increase in value of capital in no way differs from annually recurring income. A buys \$1000 face amount 10-year 8% bonds at par and receives annually \$80 income, or \$800 in all and finally gets his \$1000 back. B buys \$1200 face amount 10-year 5% bonds below par for a total of \$1000 and receives annually \$60 income, or \$600 in all and finally gets back his \$1000 plus \$200 additional. The result to B is thus the same—in ten years his \$1000 has earned \$800 for him; surely we cannot say that A's total income during the period was \$800 and B's only \$600. The situation is no different if B invests his \$1000 in a security bearing no interest during the ten years, but returning to him \$1800 at the end of the period, or if he invests in non-income yielding real estate which he sells for \$1800 at the end of the period. In all of these cases the gain, whether in equal annual instalments, or partly in annual instalments and partly at the end of the period, or all at the end of the period, constitutes income. To arbitrarily limit income to annual income is unjustified. Whatever inequity there is in taxing such gains in one year could be obviated either by apportioning them throughout the years in which the increase in value occurred and computing the tax accordingly, as has been done in England, or by allowing the taxpayer the option of including appreciation in value in his income prior to realization.

owner of the corporate assets. The tax could then be imposed on the stockholder's share of the corporate income, and the separation test applied to determine the corporate income. This the Supreme Court refused to do, stating:

"We cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized."²⁴

From this refusal to look through the corporate fiction, numerous results follow. The Revenue Act of 1918 taxes personal service corporations as though they were partnerships, by ignoring the corporate entity and taxing the stockholders upon their share of the earnings, whether distributed or not.²⁵ The unconstitutionality of this section seems to follow necessarily from the Supreme Court's premise. Congress has recognized this result and the Bill passed by the House in May, 1920, provides for the repeal of the section and the enactment of a substitute form of taxation in its place.²⁶ The Treasury Department, however, has not admitted that the stock dividend decision requires this result.²⁷

An analogous section of the Revenue Act is section 220, which taxes the profits of a corporation directly to the stockholder, in the same manner as though it were a partnership, in the case where the corporation has allowed its profits to accumulate for the purpose of enabling its stockholders to evade taxation. The constitutionality of this section would appear to be affected in a similar manner to the section taxing personal service corporations, although a distinction might be taken upon the ground that this section exists for the purpose of preventing tax evasion and that while the corporate fiction cannot usually be ignored, it can be ignored in order to prevent what is in effect a fraud upon the Government.

Even if this section is not unconstitutional, it should be noted that the freedom of stock dividends from taxation renders the section innocuous. The section declares that the accumulation of an unreasonable surplus shall be *prima facie* evidence of a purpose to escape taxation; however, as a result of the stock dividend decision no unreasonable surplus will ever be accumulated, as the surplus can be capitalized just as rapidly as it is earned. Accordingly no case will hereafter exist to which the section will be applicable.

²⁴ 252 U. S. 214.

²⁵ Revenue Act of 1918, § 218 (c), U. S. Comp. Stat. (Supp. 1919) §6336½ i.

²⁶ 66th Congress, 2nd Session, H. R. 14197.

²⁷ (1920) Treasury Bulletin No. 41, 1232.

A provision of the War Revenue Act of 1918, very similar to the preceding provisions in its ignoring of the corporate fiction, is that providing for consolidated returns.²⁸ Under it, for example, if corporation A owns substantially all of the stock of corporation B, the income of corporation B will be taxed directly to its stockholder corporation A. If the principles of the stock dividend decision are to be consistently followed out, section 240 should be declared unconstitutional.

In this connection it should be noted that demands of social policy may well require, at some not far distant date, that all corporations should be taxed as though they were partnerships and the corporate income taxed directly to the stockholders and taxes upon the corporation as such abolished. From the point of view of principle this prospect should be looked forward to, as there is really no reason why a corporation as such should pay a tax. Taxes should be imposed upon individuals and should be imposed upon them in a fair proportion to their ability to pay. Imposing taxes directly upon corporations merely tends to confuse the situation, and in fact taxes income derived from corporations more heavily than other income. While there is a social justification for taxing unearned income more heavily than earned income, there is none for taxing income more heavily merely because it happens to be derived through the conduct of business in a corporate form. At any rate, as has recently been pointed out, it is at least essential to any fair system of taxation that the same rate of tax be imposed upon the saved portions of corporate income as upon the saved portion of individual income.²⁹ The simplest way to effect this would be to tax corporate income only through stockholders. Legislation of either of these types has undoubtedly been rendered unconstitutional.

D

In addition to these results of the principles of the decision, other results follow from the actual holding, irrespective of the basis therefor.

If a stock dividend is not income it follows that a right to subscribe for additional stock is not income, for while the latter does not capitalize surplus and thus cut down the proportion belonging to the old stock, it accomplishes the same result without capitalizing the surplus, and divides up the surplus between the old and the new stock. Practically the situations are alike, and theoretically also.³⁰ Accordingly when a right to subscribe is sold it is not wholly income, but only to the extent that it represents a gain as to that portion of the

²⁸ Sec. 240, U. S. Comp. Stat. (Supp. 1919) § 6336½ ss.

²⁹ Prof. T. S. Adams, *Needed Tax Reform in the United States* (1920), (Reprinted from the New York Evening Post.)

³⁰ This identity is recognized in *Tax Commissioner v. Putnam* (1917) 227 Mass. 522, 116 N. E. 904, where rights to subscribe to stock and stock dividends were held to be income within the Massachusetts Constitution upon the same grounds.

capital which is being sold. The existing Treasury Department regulations to the contrary would seem unconstitutional.³¹

The decision also affects materially the question of income resulting from distribution of assets upon reduction of capital stock. Under the existing regulations there is no income if the amount distributed is not more than the cost of the stock surrendered.³² However, since increasing the par value of one's holdings by a stock dividend is not a gain, similarly decreasing it by accepting a reduction of capital stock is no loss. Consequently cash received upon such reduction of capital is not in repayment of rights which are being given up, for no rights are being given up, and therefore all such cash is clear income in the same manner as any cash dividend.³³

II

Thus far we have shown the necessary implications of the three fundamental premises of the stock dividend decision, and pointed out that the logical application of these principles would lead to most undesirable results. Many of these results are so fundamentally inconsistent both with our ordinary habits of thought and with considerations of practical expediency that we are lead to ask whether it would not be preferable to abandon the premises even if thereby stock dividends should be rendered taxable. We shall accordingly consider what effect a repudiation of these principles would have upon the question of the taxability of stock dividends and whether or not such effect would be harmful.

A

If the proposition that realization by separation is essential to income is repudiated, it will follow that all increase in value of capital is within the constitutional term "income" and that Congress can tax such appreciation in value whenever it sees fit. If in the case of stock, instead of taxing such appreciation every year, Congress were to

³¹ Regulations 45, Art. 39. Prior to the stock dividend decision it would have seemed proper to treat rights to subscribe as income to the extent of their fair market value, even though not sold, but this position has never been taken by the Treasury Department. "There are three possible views as to the treatment for purposes of income taxation of rights to subscribe for stock: (1) That such rights are income when issued; (2) that the proceeds of the sale of such rights are income at the time of sale; (3) that the proceeds of a sale of rights are a return of capital to the stockholder and are taxable only if and to the extent that they exceed in amount the cost, or market value on March 1, 1913, of the stock upon which they were issued. As above indicated, the second position has been consistently held by the Bureau, though strong arguments can be advanced for each of the other views." (1919) Treasury Bulletin No. 19, 495.

³² (1920) Treasury Bulletin No. 43, 1254.

³³ If this is not the law a corporation can declare a 100% stock dividend, thereby bringing the average cost of its stock down to \$50 per share, and it can thereafter reduce its capital stock to the original amount and distribute \$100 per share to its stockholders. Under the existing regulations the stockholder's income would be but \$50 though he has really received \$100.

tax it only from time to time as stock dividends are declared, such action would be wholly proper. By abolishing the realization test, the doctrine that income is income only at one exact point in time is also given up; and the legislature is free to single out the particular moment when it will impose the tax; it can exercise its discretion in choosing any step upon the stairway leading from the first accrual of inchoate rights to the final complete realization in cash.

One qualification of this theory of supporting a tax on stock dividends must be noted. If a stockholder buys his stock after the appreciation in value has already come about, in whole or in part, it cannot be said that the stock dividend represents income to him to its full market value. It is obviously improper to add to the taxpayer's income as appreciation of his capital the market value of the stock dividend received by him without simultaneously allowing him to deduct the depreciation in value of his old stock below its cost. Under the 1918 Act now in force, it is declared that income "includes gains, profits and income derived from . . . dividends . . .".³⁴ In the case of the original subscriber to the corporation's stock, the gain from the stock dividend would be the full market value of the stock; in the case of subsequent purchasers it might be less than that, depending upon the price they had paid for their holdings. However, even recognizing this qualification, if the realization test were repudiated there could be no question about the constitutionality of this statute.³⁵

B

The second proposition of *Eisner v. Macomber* is that the separation necessary to constitute realization must consist both of a payment out of the corporate treasury and gain to the stockholder. Irrespective of whether realization as a test of income is to be repudiated, if this particular definition of separation is repudiated, another definition of separation can be adopted which will render stock dividends taxable.

There is no inherent reason either in economics or law why the particular test of separation laid down in *Eisner v. Macomber* must be followed. On the contrary, the more reasonable test of separation would be to ask whether the stockholder, whose income is to be taxed, has something separate from what he had before the dividend was paid. A stockholder's interest cannot be more exactly defined than as a bundle of rights of various natures. The test consequently should

³⁴ Sec. 213 (a), U. S. Comp. Stat. (Supp. 1919) § 6336½ h.

³⁵ It should be noted that *Eisner v. Macomber* actually involved the 1916 Revenue Act, which expressly stated that a "stock dividend shall be considered income to the amount of its cash value." Upon the theory now under discussion it would be necessary to strike out from the statute the words "to the amount of its cash value" and construe the remaining language to the effect that a stock dividend shall be considered income to the extent that it represents a gain to the stockholder.

be:—has the stockholder received anything separate from and in addition to his pre-existing bundle of rights.

A stock dividend meets this test. It is the creation of a new bundle of rights in addition to and separate from those preëxisting. The original rights of a holder of a \$100 share consist chiefly of the right to have \$100 retained as capital and the right to a share in the corporate surplus and earnings measured by the proportion between \$100 and the total issued capital. After a stock dividend of 5% has been declared, while the stockholder continues to own his original share with its original rights unimpaired, he now has in addition to those rights a new bundle of rights, consisting of the right to have an additional \$5 retained as capital and the right to a portion of the earnings and surplus to be determined by the ratio between \$5 and the total issued capital. This change in the stockholder's rights is a very real one and this addition to the stockholder's rights creates a very different legal situation. After the stock dividend has been issued and the capital stock of the corporation increased, the directors have thereby lost their right freely to use that portion of the surplus which has been capitalized. It cannot be used for the payment of dividends, nor can it be used for the purchase of the corporation's own shares. The consent of a large proportion of the stockholders is now necessary in order to bring about a reduction of the capital stock and re-create the surplus.³⁶ Furthermore, in many jurisdictions not even with the consent of the stockholders can the capital stock be reduced unless approval be obtained from the proper governmental official.³⁷ By capitalization, the surplus has thus become crystallized. In effect, what theretofore was distributable in dividends or otherwise has now become permanently added to the stockholder's original investment in the company and the stock dividend is the embodiment of this new right of the stockholder to have an additional \$5 permanently retained in the company.

That this right is a substantial one is further shown by the fact that its coming into existence is considered a justification for imposing additional obligations upon the stockholder, in that his personal liability for the corporate debts may be thereby increased. In the case of national banking associations, as well as under the laws of some states, stockholders have been made liable to the creditors of the corporation to a certain number of times the par value of the stock owned by them.³⁸

³⁶ 5 Fletcher, *Cyclopedia Corporations* (1917) § 3471.

³⁷ New York Stock Corporation Law, Cons. Laws (1909) c. 59, § 64; Machen, *Modern Law of Corporations* (1908) § 643-4. Under some statutes assent of creditors is a condition to reduction, *id.* § 652.

The analysis suggested is equally applicable to corporations having stock without par value, for even in such corporations a distinction is made between capital and surplus and a stock-dividend transfers some preëxisting surplus into capital, even though the amount is small.

³⁸ U. S. Comp. Stat. (1916) § 9689; similar statutes formerly existed in

A stock dividend thus creates a new bundle of legal rights, wholly apart and distinct from those existing. The existing bundle of legal rights is in no way changed or affected other than that its value is decreased because of the decrease in the proportion of surplus and earnings represented thereby; in this respect, however, the situation is identical with that of a cash dividend and the simultaneous sale of additional stock either to the stockholder or to the public.³⁹ In all other respects the existing bundle of rights is unchanged.⁴⁰

Nor can it be urged that at least in the case of a dividend in common stock as distinguished from one in preferred stock, there is no income because there is merely a dividing in two of what existed before. It is of course true that the separation necessary to constitute income must be something more than a mere dividing of existing rights into two parts, each of which is identical with the other and each of which is one-half of the preëxisting rights. Such a case of division of capital exists when the par value of stock is reduced from \$100 to \$50 and the number of shares doubled. There the stockholder originally possessed a bundle of rights, chief of which was the right to have \$100 kept as capital of the company and not to be distributed as dividends; he also had the right to a share in the surplus of the corporation measured by the proportion between \$100 and the total issued capital stock. After the par value of the stock has been cut in two he

Kansas and Maryland. The same is also true of National Farm Loan Associations under the Federal Farm Loan Act, U. S. Comp. Stat. (Supp. 1919) § 9835, e (4).

³⁹ An illustration will make this clear: Two corporations have each a surplus of \$110 per share. Corporation A declares a 5% stock dividend which brings the surplus per share down to \$100 and gives the old stock 100/105 of future earnings. Corporation B declares a 10% cash dividend and gives its stockholders the right to subscribe to a 5% increase of stock at its book value, namely, twice par, which right would presumably therefore have no market value. The old stock would then also represent 100/105 of the future earnings and also have \$100 per share surplus. In the second case it is recognized that whether the stockholder exercises or waives his right to subscribe, he has income to the extent of \$10 per share, in addition to his preëxisting capital, and that his old rights exist unimpaired though decreased in value. It follows equally that in the first case the original rights continue unchanged, and that the stockholder has in addition his stock dividend.

⁴⁰ The fact that a stockholder may, by exercising his so-called preëmptive right, maintain his proportionate interest in the corporation, does not mean that changing that proportionate interest cuts down his original rights. He merely has the privilege if the stock is to be increased to add to his holdings. If the right to subscribe to new stock is offered at such a price as to make the right itself have no value and he elects not to subscribe, certainly his old rights are not thereby cut down. On the contrary he has all his old rights, but they are now in a corporation with an increased capitalization and therefore represent a smaller proportion of the whole. Where the right to subscribe is at such a price that the right itself has value, and is sold by the stockholder, the same is still true, although in that case the old stock has decreased in value while its rights are unchanged. In the case of a stock-dividend the situation is no different, as has been pointed out above from another aspect, and the old rights are unimpaired and merely lessened in value. That this disregard of the change of proportionate interest is correct is further established by a consideration of those corporations where by charter provision the stockholder has no preëmptive right at all.

now possesses two bundles of rights, each of the same terms, namely, a right to have \$50 kept intact as capital and a right to a proportion of the corporate surplus measured by the ratio of \$50 to the total issued capital. The right of the holder of one share of \$50 par value is exactly one-half of the rights of the previous holder of a \$100 share, and the rights attached to the two shares of \$50 each when added together are equal to the rights of the holder of the original \$100 share. Because of this there has been no income and no separation of additional rights, but merely a dividing in half of existing rights. This situation is entirely different from a 100% stock dividend where, as has been shown, new rights separate from and additional to the old have been created.⁴¹ While this distinction may seem artificial, it is in fact fundamental; if separation is to be used as the test of income the difference between separation and division is of vital importance and the line cannot be drawn at any other point than between a stock dividend and a mere change in the par value of stock.

Notwithstanding this demonstration that separation exists in the case of a stock dividend, the reader may hesitate to admit that it is really income and may still feel that the recipient of a stock dividend has received no income. This feeling is ascribable chiefly to the fact that stock dividends are usually large in amount and infrequent, while cash dividends are small and regular. This fact, however, is accidental. Consider the case of a corporation which for ten years has annually earned 5% on its stock, but in order to increase its working capital has throughout that period declared quarterly stock dividends instead of cash dividends. Does it trouble us to recognize that those stock dividends, provided they have a market value, are income as received? In contrast take the case of an extraordinary cash dividend of 150% declared a short time after A has bought his stock, which causes a large decrease in the value of the stock. Does it not seem unfair to treat that entire cash dividend as income? In other words, the real

⁴¹ The distinction between a 100% stock dividend and a cutting of the par value of stock in two is further emphasized by considering the legal effects of a stock dividend upon the corporation. Under the laws of some jurisdictions the amount of money which a corporation may borrow is limited in a certain proportion to its capital stock; the increase in the capital stock thus increases the borrowing power. Ohio Genl. Code (P. & A., Supp. 1916) § 8705. Again, in other jurisdictions the amount of preferred stock which a corporation may issue is limited to a certain percentage of the total capitalization. In those jurisdictions by issuing a stock dividend, the possibility is created of financing by selling additional preferred stock. New Jersey Corporation Act, Sec. 18, N. J. Comp. Stat. (1910) p. 1608. Again, the right of corporations, especially public utilities, to declare dividends is sometimes limited to a certain percentage upon the capital stock; the creation of a stock dividend affords an opportunity for thus paying the stockholder greater dividends. *Bailey v. Railroad Company* (1874) 22 Wall. 604. Finally, in connection with questions of income taxation itself, the increase of capital stock may greatly benefit the corporation. Thus under the Income Tax Law of 1913, 38 Stat. 172, a corporation was allowed to deduct interest paid on its indebtedness to an amount of such indebtedness not exceeding one-half of the indebtedness together with its capital stock. Section II, G (b).

ground for objecting to recognizing stock dividends as income is the feeling that all extraordinary dividends, whether in cash or in stock, are a part of capital rather than income. This position is, however, untenable. If decreasing the value of the stock were the criterion, since every regular quarterly dividend, when paid, leaves the stock worth less than before, it would follow that all dividends are capital and not income. At any rate, even if this were not so, no satisfactory distinction can be drawn between ordinary and extraordinary cash dividends. Nor can it be urged that stock dividends are always large and irregular and cash dividends the contrary: such is not the case and no separate classification upon such a ground is possible.⁴² In short, stock dividends are as much income as cash dividends and we cannot consistently treat one as income and the other not.

Upon the definition of separation suggested herein it follows that a stock dividend is income to its full value even to a stockholder who purchased his stock at a date after the surplus subsequently capitalized by the stock dividend had been in whole or in part built up. It is true, as already pointed out, that neither cash dividend nor stock dividend is necessarily wholly a gain in such a case. What really occurs is that in the case of an extraordinary cash dividend or a stock dividend, and even in the case of an ordinary cash dividend, simultaneously a stockholder receives income in the form of dividend and has an as yet unrealized loss on his principal. A homely illustration may serve to bring this point out more clearly. A farmer buys a mare about to foal. The foal is born and is sold by the farmer. The full value of the foal is income, notwithstanding the fact that the value of the mare decreased to a very considerable extent after the foal was born.

If the Supreme Court's test of separation is repudiated and the definition suggested adopted, the consequences resulting from that test, as heretofore pointed out, would be avoided and a logical and workable meaning would be given to separation.

C

Even if the Supreme Court's definition of separation is retained, stock dividends would be still taxable if the corporate entity were to be ignored and the test of separation then applied to the corporate income.

In many cases courts have not hesitated to disregard the corporate fiction and to declare that in effect the stockholders are the owners of the corporate assets and that the corporation is merely a piece of machinery for that purpose.⁴³ Upon this theory the legislature could im-

⁴² In many corporations small stock dividends are given in addition to cash dividends and with equal regularity. On the other hand for a case of an extraordinary cash dividend of 552%, see *Richmond v. Richmond* (1908) 123 App. Div. 117, 108 N. Y. Supp. 298.

⁴³ See *Piercing the Veil of Corporate Entity*, I. Maurice Wormser (1912), 12 COLUMBIA LAW REV. 496.

pose a tax upon the individual stockholder, upon his *pro rata* share of the corporate earnings during the year, even though undistributed. Since, however, the stockholder's ability to dispose of those earnings while they are a part of the fluctuating surplus is limited, it would appear permissible and even more consistent with the realization test of income to postpone imposing the tax until those earnings have come more completely into the stockholders' control; that is to say, until they are distributed as cash dividends or capitalized as stock dividends.

This view it will be noted leads to one qualification of the taxability of stock dividends: stock dividends which capitalize accretion to capital of the corporation instead of earnings, would of course not be income.⁴⁴ Subject to this qualification both cash and stock dividends would be income to their full value irrespective of whether or not the earnings distributed or capitalized were accumulated before the stock was bought; for the dividend declaration which puts the income into disposable form constitutes the final act of realization, and is income irrespective of any shrinkage in value of capital which also results from it.

D

If any one or all of the three propositions of *Eisner v. Macomber* are repudiated, stock dividends will thus be taxable. Such a result will be desirable for its immediate effects, as well as for the more far-reaching effects previously pointed out.

By exempting stock dividends from taxation, postponement, inequality and even evasion of taxation result. Not only is there a postponement of the accrual of the tax from the time when the dividend is received to when it is sold, but when sold the tax is imposed not on the full proceeds but only upon the gain over the cost of the stock sold, which is determined by apportioning the original cost of the stock upon which the dividend was declared.⁴⁵ Accordingly this unequal result is reached: A and B each own the same number of shares in different corporations, which they have bought at par. A's corporation declares a 100% cash dividend and gives A the right to subscribe to 100% additional stock which A elects not to exercise. B's corporation declares a 100% stock dividend and B disposes of this stock for cash at par. As a result of the transactions both A and B have received identically the same amount of cash and are in all other respects in identically the same situation in relation to their respective corporations. Yet A's taxable income is \$100 per share, while B's taxable income is only \$50 per share.

Moreover, even this postponed partial tax upon the sale may not

⁴⁴ This limitation would not invalidate existing income tax legislation, for no attempt is made to tax even cash dividends unless declared out of corporate profits as distinguished from appreciation in value of corporate assets. Revenue Act 1918, Sec. 201 (a) (1), U. S. Comp. Stat. (Supp. 1919) § 6336½ b.

⁴⁵ Regulations 45, Art. 1547.

be received by the government. As has been pointed out above, through the loophole in our tax system, either by *inter vivos* or by testamentary disposition the recipient of the stock dividend can transfer it to a relative and in such a case the entire tax is evaded. The effect of the stock dividend decision is to extend this loophole, as well as to make it more difficult to stop the loophole, as has been heretofore shown.

Finally, stock dividends should be taxed as a matter of policy because no type of what is ordinarily considered as income can be exempted from taxation without creating a sense of injustice in the community. In common Wall Street parlance a stock dividend is spoken of as "cutting a melon". It is undesirable to exempt such income from taxation.

III

The consequences of the principles of *Eisner v. Macomber*, which follow necessarily if logic is adhered to, have been pointed out, and the harmful nature of these consequences needs no stressing. The advantages of repudiating those principles and treating stock dividends as taxable income have also been shown.

Undoubtedly the Supreme Court will not be consistent and will avoid many of these logically necessary conclusions in one way and another. Most of them, however, unquestionably cannot be dodged, nor can the immediate effects of the decision be cured, without a reversal of *Eisner v. Macomber*. A direct reversal is not probable; the most that can be hoped for is that this decision construing the Sixteenth Amendment will be followed by countless others limiting and modifying the decision step by step. At best this cannot overcome all the consequences of the decision, and the only complete solution is a new amendment to the Constitution for the purpose of construing the Sixteenth Amendment. Such an amendment should make it possible for Congress, in its discretion, to use any of the possible tests of income and to choose any of the various times when income can be considered as income. To this end such an amendment could not do better than contain in a preamble a reminder to the courts of the principle enunciated by Chief Justice Rugg in construing "income" in the Constitution of Massachusetts:

"But in the framing of constitutions words naturally are employed in a compendious sense as expressive of general ideas rather than of the fine shades of close distinctions. The simple and dignified diction of our Constitution does not readily lend itself to technical and narrow definition. Terse statement of governmental principles in plain language, and not amplification in the delicate niceties of words, characterizes its composition."⁴⁶

And it should then define income as used in the Sixteenth Amendment in the language of that same Justice:

⁴⁶ *Tax Commissioner v. Putnam* (1917) 227 Mass. 522, 528, 116 N. E. 904.

"the word 'income' was there used with the purpose of setting at rest any doubt about the full and complete power of the Legislature to deal with 'income' as a subject of taxation. That word was employed to express a comprehensive idea. It is not to be given a narrow or constricted meaning. It must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income."⁴⁷

EUSTACE SELIGMAN

NEW YORK CITY

⁴⁷ *Ibid.* 525.